

# **LONG-RANGE BUILDING “CASH” PROGRAM FUNDING**

A Report Prepared for the  
**Legislative Finance Committee**

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September 23, 2005

**Legislative Fiscal Division**



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## **INTRODUCTION**

The Long-Range Building Program (LRBP) “cash” program is not sufficiently funded, and without legislative action to address the diminishing revenue base, inflationary increases in repair cost, and increases in asset inventory, the program will eventually be reduced to a level that will be detrimental to the state’s capital assets. Current LRBP funding is approximately 20 percent of the recommended level that is considered sufficient to avoid adding to the state’s backlog of major facility repairs and maintenance. Without changes in program funding, only the most urgent of needs, roof replacements and life safety projects, will be initiated in the future.<sup>1</sup>

Recognizing the growth of the facility deferred maintenance backlog, the 2005 Legislature authorized an appropriation of \$8,000 for a “Long-range Building Program Funding Study”, with the intent of producing a quantification of current deferred maintenance, an analysis of the problem, a recommendation for adequate LRBP cash program funding, and a proposal for the elimination of the backlog. The Legislative Finance Committee (LFC) included this project in the staff work plan adopted at their June 2005 meeting. Legislative Fiscal Division (LFD) staff will work with the Division of Architecture and Engineering (A&E) personnel to conduct the study.

The LRBP cash program has historically been used to manage the major repairs and maintenance on qualifying state buildings. LRBP qualifying facilities make up approximately two-thirds of the state’s entire building inventory. This report will not discuss funding approved for non-LRBP eligible projects<sup>2</sup>, which are also authorized in the Appropriation Subcommittee on Long-Range Planning. Non-eligible projects are often funded with state and federal special revenue funds. Furthermore, this report will not delve into the LRBP bond program, which is typically used to fund new construction, extensive remodeling, and significant upgrades of state facilities. Instead, this report will focus on the problem of inadequate funding in the building maintenance program, or “cash” program.

The purpose of this report is to gain legislative awareness of the problem by providing the members of the LFC with a preliminary assessment of the magnitude of the funding deficiency in the LRBP cash program, and to provide options for committee participation in the study. This report has five major sections.

- The first section will provide discussion on the current inventory of state buildings. Included will be analysis of the most recent building inventory and the potential for future growth. Furthermore, this section will assign a preliminary value to the maintenance costs of the state’s building inventory.
- The second section will feature a brief synopsis of the recognized backlog in deferred maintenance facing the state and a projection of the growth expected in the deferred maintenance backlog.
- Section three will provide an analysis of the current LRBP cash program funding.

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<sup>1</sup> This statement assumes no additional funding such as the one-time general fund transfer approved in the 2007 biennium budget. Also assumed is that future legislatures will not approve bonded funds for deferred maintenance projects.

<sup>2</sup> Some examples of non-LRBP eligible facilities include University System dormitories, PHHS Veteran’s Homes, and FWP hatcheries. Maintenance on these and other non-LRBP eligible facilities are funded with state and federal funds.

- Section four will compare projected costs to projected revenues and present a snapshot of the future for the LRBP.
- A summary of this analysis will be included in the last section.

## STATE BUILDING INVENTORY

The LRBP was developed in 1963 to provide a single comprehensive program to oversee the construction, repair, and maintenance of state-owned buildings and grounds. The state has many buildings in its care, and the number of buildings grows with each legislative session. Of the total inventory, two-thirds (66.2 percent) of the buildings fall under the responsibility of the LRBP for major repairs and maintenance.

The most recent building inventory, maintained by the Department of Administration, Risk Management and Tort Defense Division and completed for fiscal year end 2004, documents a total of 1,893 state-owned buildings with structural replacement values of greater than \$50,000. The value limitation serves to exclude structures such as Department of Transportation storage sheds and Department of Fish, Wildlife and Parks latrines. A summary of the inventory by agency can be seen in the chart below. Of

<b>State of Montana</b> <b>State-Owned Buildings, Values Exceeding \$50,000</b> as of Fiscal Year End 2004					
<b>Agency</b>	<b># Buildings</b>	<b>Square Feet</b>	<b>Building Value</b>	<b>% Value</b>	<b>% Sq Feet</b>
Department of Administration	40	1,340,288	\$174,924,143	10.10%	6.93%
Department of Agriculture	1	7,888	437,816	0.03%	0.04%
Department of Commerce	68	253,165	23,811,043	1.37%	1.31%
Department of Corrections	99	1,125,435	107,488,566	6.21%	5.82%
Department of Environmental Quality	13	346,666	2,945,511	0.17%	1.79%
Department of Fish, Wildlife, and Parks	148	501,963	30,707,055	1.77%	2.59%
Department of Justice	14	93,733	6,010,935	0.35%	0.48%
Department of Labor and Industry	13	89,987	7,584,271	0.44%	0.47%
Department of Military Affairs	47	559,393	43,703,036	2.52%	2.89%
Department of Natural Resources & Conservation	64	236,861	23,895,171	1.38%	1.22%
Department of Revenue	1	91,781	3,839,140	0.22%	0.47%
Department of Transportation	436	1,486,374	97,864,951	5.65%	7.68%
Historical Society	8	28,359	3,606,535	0.21%	0.15%
Office of Public Instruction	3	1,920	41,645	0.00%	0.01%
Public Health and Human Services	103	1,093,579	89,442,834	5.16%	5.65%
State Board of Education	14	163,405	15,426,529	0.89%	0.84%
State Fund	2	79,762	6,668,421	0.39%	0.41%
University System	<u>819</u>	<u>11,849,411</u>	<u>1,093,465,551</u>	63.14%	61.24%
	<u>1,893</u>	<u>19,349,970</u>	<u>\$ 1,731,863,153</u>	100.00%	100.00%

the total 19.3 million square feet of state-owned space, over 61 percent are controlled by the university system. Not included in this inventory are structures approved for construction and major upgrades by past legislatures but not yet constructed, including:

- Three new buildings and three major renovation projects approved in the 2001 legislative session
- One new building, one addition, and two major renovation projects approved in the 2003 legislative session

- Ten<sup>3</sup> new buildings, two additions, and four major renovation projects approved in the 2005 legislative session

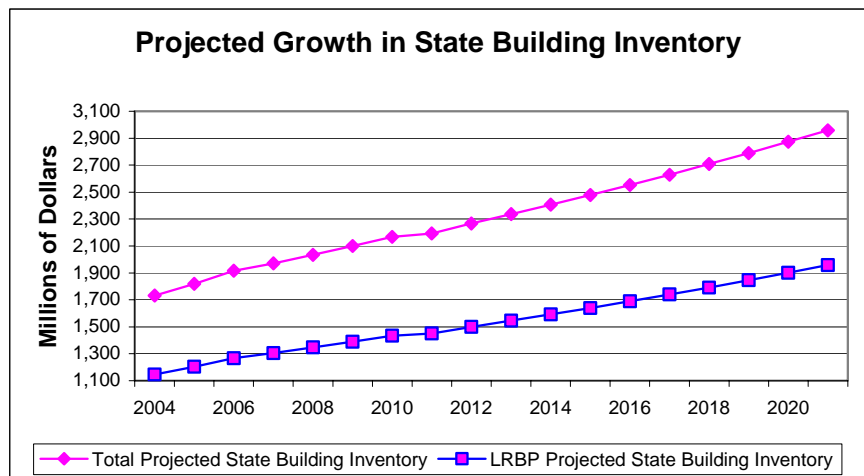
The uncompleted projects will add an estimated 780,380 square feet to the state's building inventory, 87 percent of which will be additions to the university system.

The survey, completed at fiscal year end 2004, shows the current replacement value of the state inventory at over \$1.73 billion dollars. As mentioned above, the LRBP is obligated for maintenance of approximately 66.2 percent of the total of state-owned buildings. Consequently, at the end of fiscal 2004, the LRBP was responsible for the major maintenance of \$1.15 billion in state owned buildings. This value is greatly influenced by both inflation and with the addition of new buildings to the state inventory.

In the near future the replacement value of state owned buildings will show a significant increase resulting from inflation and newly approved buildings and improvements. Due to recent and significant increases in construction costs, the staff at A&E believes the value given in the 2004 inventory is now understated by 5 to 10 percent. On the conservative side (at 5 percent), the inventory is thought to be valued at an additional \$86.6 million. A calculation of the new construction and significant renovations of state buildings approved or appropriated but not yet constructed shows that the inventory will increase by approximately \$211.3 million when all the projects are completed. By combining the impact of inflation and new facilities, soon the expected value of the state building inventory will surpass \$2 billion. This translates to a replacement value of \$1.29 billion in state-owned buildings eligible for maintenance through the LRBP.

The state-owned building inventory will continue to increase as future legislatures authorize the constructions of new buildings. Although the number of facilities that will be authorized in future

biennia is subject to many variables, analysis of the LRBP over the past decade shows that the legislature authorizes an average of five new buildings each biennium. The average cost per building approved in the 2005 Legislature was \$10.5 million. As shown in the chart to the right, if new construction continues at this rate into the future and adjusting for inflation, the state can expect to have a total inventory equal to almost \$<sup>4</sup> billion by 2021, a compound growth rate of 3.2 percent annually. With that, the LRBP cash program will be required to provide major maintenance for almost \$2 billion worth of state owned buildings by the 2021 biennium.



<sup>3</sup> For the purpose of this report, new buildings approved in the appropriation for agricultural experiment stations are counted as one building.

<sup>4</sup> This figure combines: the current inventory, the A&E estimate for an expected increase of 5% in value, the construction value of buildings approved in past biennia but not yet included in the current inventory, an average of 5 buildings per biennium at an average cost of \$10.5 million per building, inflation of 3% on current values and inventory additions.

Generally recognized industry standards recommend between 2 and 5 percent of a building's current replacement value be reinvested annually in maintenance to avoid generating a deferred maintenance backlog.<sup>5</sup> However, this recommendation includes routine and preventative maintenance, which the state funds in the operating and maintenance budgets of the agencies. A&E recommends 1 percent annually as a goal to address the major repairs and maintenance needs funded by the cash program.<sup>6</sup> This 1 percent recommendation becomes credible with evidence that other states make use of the standard. More information about how other states fund their capital maintenance programs will be presented in a future meeting. The LRBP cash program would need project funding of \$11.5 million per year, \$23 million per biennium under a 1 percent scenario, and that amount would need to increase with inflation and the addition of new and renovated space.

## **DEFERRED MAINTENANCE BACKLOG**

The LRBP has been inadequately funded for nearly two decades. The deferred maintenance backlog is the consequence of lack of adequate funding in the LRBP cash program. The cost of deferred maintenance increases both with the passage of time and as additional major maintenance projects are postponed. In the February 2005 issue of *Governing* magazine, former budget director Chuck Swysgood states that the deferred maintenance backlog for state-owned buildings is \$181 million.<sup>7</sup> The 2005 Legislature made significant headway in reducing this problem with the approval of a biennial budget containing a one-time general fund transfer of \$30.1 million. Additionally, the normal LRBP budget of approximately \$5 million was directed in large part to reduction of deferred maintenance. However, under the current funding regime major maintenance projects will continue to fall into the deferred category.

The A&E staff is currently evaluating the deferred maintenance in the state. Staff is conducting a survey of all state agencies to determine a total picture of the deferred maintenance backlog. Preliminary estimates show the backlog to be approximately \$142 million, which closely agrees with the estimate by former budget director Swysgood when reduced by the appropriations for the 2007 biennium.

The funding deficiency in the LRBP causes the backlog in deferred maintenance to grow. Each year that major maintenance projects are not funded, the backlog increases. Additionally, projects become more costly with inflation and as the wear and tear on the facility continues. At current funding levels, the deferred maintenance backlog is expected to grow at an annual rate of 3.97 percent each year. At this rate, the backlog of deferred maintenance will grow to \$244.9 million by fiscal 2021. One area for further study is whether adequate funding (\$11.5 million annually) of the LRBP cash program will in time reduce the current deferred maintenance backlog to an acceptable level.

## **CURRENT FUNDING OF THE LONG-RANGE BUILDING PROGRAM**

While not readily apparent in the 2007 biennium, the Long-Range Building Program (LRBP) continues to experience reduced revenues that could become a significant problem in the future. The LRBP cash program has been supported by distributions from the cigarette tax for many years. Coal severance tax support was added to the LRBP to provide debt service backing for three bond issues and has since

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<sup>5</sup> Association of Physical Plant Administrators and American Public Works Association.

<sup>6</sup> This statement applies the assumption that operations and maintenance budgets would continue to be used to address preventative and minor maintenance and replacement needs. Additionally, it assumes that bonded programs would address maintenance needs more appropriate for inclusion in a major renovation effort.

<sup>7</sup> This figure pre-dated the one-time general fund infusion of \$30 million in the 2007 biennium LRBP budget.

become increasingly important in supporting the cash program. These two revenue sources provide the greatest part of the funding for the LRBP. Unfortunately, both the cigarette tax and the coal severance tax sources have experienced diminishing revenue collections, and the base of the cigarette tax is expected to further decline in future years.

## LRBP CIGARETTE TAX DISTRIBUTIONS

The cigarette tax is the main funding source for the LRBP. While the cigarette tax does not bring the greatest sum of money into the program, it does provide the greatest amount of non-dedicated funds. As observed in the table at the right, the LRBP allocation of cigarette revenues have changed dramatically over the years.

From 1986 to 2002, changes in the allocations were typically the result of changes in the LRBP obligations to bonded debt. In addition to cigarette tax allocations for projects, a separate allocation was provided to pay the debt service obligations of additions to the state's building inventory. In years when those obligations were changed, for example 1990 through 1993, the allocation of cigarette taxes were also changed. One noteworthy allocation change occurred in 1993 when the legislature decided to break funding for upkeep and maintenance of the state's Veteran's Homes out to an individual fund. At that time, the LRBP allocation was reduced by nearly 7 percent, causing a reduction of funding of \$1.3 million, or 38 percent.

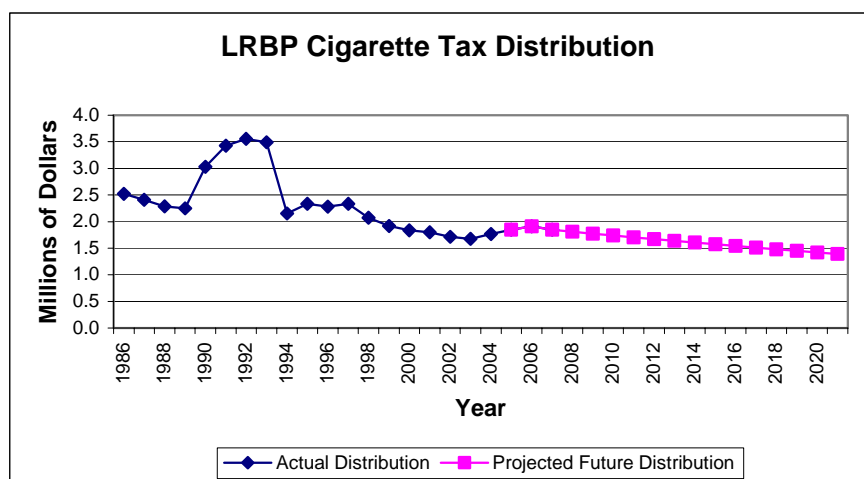
Beginning in fiscal 2003, LRBP allocations of cigarette revenue were reduced twice with increases in the tax rate. The changes in allocation were an effort to hold the program funding "harmless" to the rate changes. In each recent case of allocation change, funding for the LRBP has actually increased slightly.

In the mid-1980's, the LRBP received nearly \$2.5 million of cigarette tax dollars annually, and the dollars have been steadily decreasing since. The LRBP is

expected to receive \$1.9 million in fiscal 2006 and \$1.8 million in fiscal 2007. Over the two decades, this equates to a reduction of 27 percent in nominal terms. Furthermore, the LFD assumes that cigarette sales will continue to decrease at a level of approximately 2.6 percent annually. Consequently, cigarette tax distributions to the LRBP will diminish to \$1.5 million in the next decade. The chart at the right illustrates both the historic and projected declines in LRBP cigarette distributions.

<u>FY</u>	<u>LRBP Distribution</u>	<u>LRBP Allocation</u>
1986	\$2,524,531	20.25%
1987	2,408,680	20.25%
1988	2,283,861	20.25%
1989	2,250,400	20.25%
1990	3,028,489	25.42% *
1991	3,427,220	29.11%
1992	3,557,535	29.11%
1993	3,489,490	27.21%
1994	2,152,068	20.25%
1995	2,336,089	20.25%
1996	2,280,816	20.25%
1997	2,335,038	20.25%
1998	2,071,059	15.85%
1999	1,914,569	15.85%
2000	1,836,680	15.85%
2001	1,797,821	15.85%
2002	1,711,492	15.85%
2003	1,676,385	4.30%
2004	1,767,440	4.30%
2005	1,849,000	3.45% *
2006	1,914,000	2.60%
2007	1,847,000	2.60%

\* Blended allocation rate in mid-fiscal change

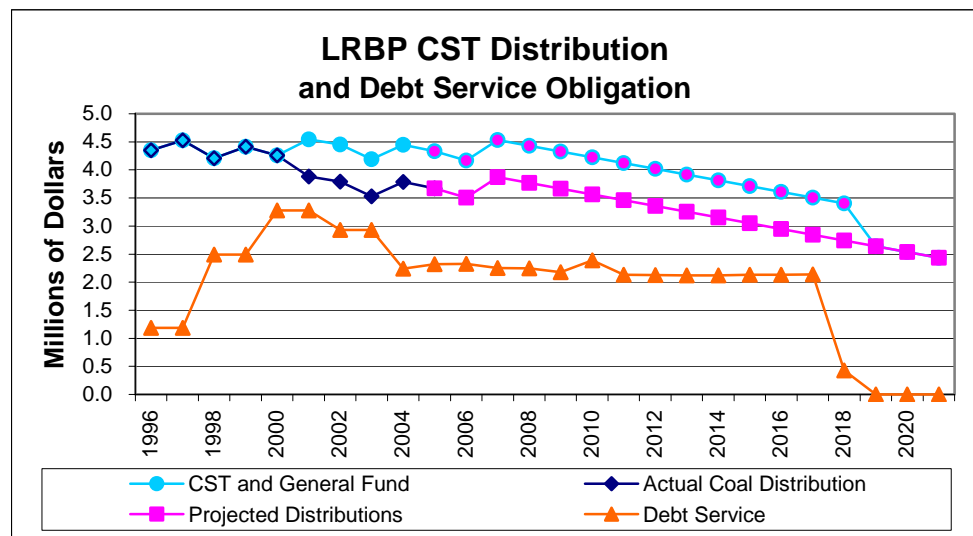


## LRBP COAL SEVERANCE TAX DISTRIBUTIONS

In 1996, the LRBP began receiving a distribution of the coal severance tax. The tax was dedicated in large part for the debt service of approved bond issues in the 1997 legislature. The distribution of 12 percent has not changed, but decreases in coal production and price have led to a reduction in the distribution of coal taxes to the LRBP.

As mentioned above, coal tax distributions were added to the LRBP in 1996 primarily to pay debt service on bonded debt issued for projects approved in the 1997 biennium. Further actions in the 2001 legislative session directed \$665,000 in general fund dollars annually to the LRBP account for the payment of debt service. Only the general fund distribution is specifically designated to the debt service, so any coal tax revenues remaining after the debt service payments are available for LRBP

expenditures and projects. As observed in the chart to the right, dollars flowing into the LRBP to cover the debt service have always exceeded the total debt service obligation, preserving funds for use in LRBP projects. In the 2007 biennium the LRBP had \$2.8 million dollars in coal severance funds available for the program.



The chart to the right is useful in demonstrating the relationship between the coal severance tax and the debt service obligation. Bonds, payable with coal severance tax funds, were issued for the approved projects over a 5-year period. Note the savings in interest realized with the refinance of those issues during the 2005 biennium. In 2019, when the debt service on these bonds is paid in full, the general fund distribution is scheduled to end, and the entire distribution of coal severance taxes will be available for the LRBP.

## OTHER LRBP INCOME

The LRBP receives income from several other sources, yet the income is less significant in the funding of the program as a whole. Three sources of income that occur on an ongoing basis are fees charged by A&E for the supervisory activities, energy savings realized through the State Building Energy Conservation Program (SBEC), and interest earned from deposits of the earlier mentioned sources. There have been two instances where general fund dollars were transferred directly into the LRBP, including the transfer of \$30.1 million in the current biennium for remediation of the backlog of deferred maintenance that exists in the program. In the past, the LRBP has made use of project reversions for future projects; as seen in the chart below, this last occurred in the 1993 biennium. In past years, the program also received deferred payments and interest earnings from the coal tax. Typically, the other incomes generate near \$1 million each biennium for the program.

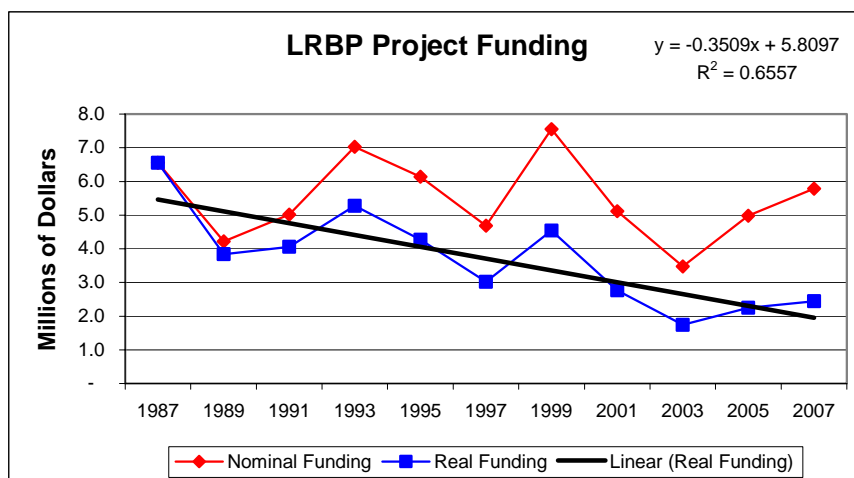


LRBP "Other" Income								
Bien	Interest Earnings	Supervisory Fees	Energy Savings	Deferred Payments	General Fund	Reversions	Coal Tax Interest	Total
1987	\$2,110,167	\$120,000				\$450,000		\$2,680,167
1989	668,065	120,000		20,000				808,065
1991	466,053	175,000		20,000		1,100,000		1,761,053
1993	400,000	142,000				1,000,000		1,542,000
1995	400,400	142,000			2,600,000			3,142,400
1997	441,000	262,000	320,000				332,000	1,355,000
1999	751,813	602,020	414,865					1,768,698
2001	918,768	682,884	347,003					1,948,655
2003	330,792	365,010	287,993					983,795
2005	251,100	202,192	404,295					857,587
2007	507,827	301,712	159,741		30,100,000			31,069,280

## TOTAL PROJECT FUNDING

Total project funding<sup>8</sup> for the LRBP cash program has diminished through time, and currently the program is significantly under-funded. In nominal terms, project funding in the 1990's averaged approximately \$6 million a biennium. Funding since 2000 has averaged only \$4.8 million a biennium. The change of \$1.2 million represents a reduction of 25 percent in total project funding.

In real terms, the reduced funding is even more alarming. Given in 1987 dollars, the reduction in average funding between the decades amounts to almost \$2 million. A simple trend on the LRBP real funding shows a decrease of \$350,000 per biennia. The trend analysis shows an  $R^2$  value of 65.6 percent, meaning that 65.6 percent of the variation in project funding can be explained by the passage of time. The estimated decline in real project funding is measured at 60 percent in the decade between fiscal 2007 and fiscal 1987.



Increases in project funding during the last two biennia can be attributed to two factors, the change in the allocation of cigarette tax distributions, which created a slight increase in revenues, and the re-issuance of LRBP bond issues, which reduced the interest obligation to the LRBP. At the current level of funding, the deferred maintenance backlog will continue growing. Factors affecting the growth include both inflation and the lack of adequate funding to address the ongoing cost of major maintenance in state buildings.

## PUTTING IT TOGETHER; FIXED COSTS AND PROJECTS

Increasing maintenance requirements and decreasing funding combine to present a particularly bleak picture for the future of the LRBP cash program. Inadequacies in funding have grown since the mid-1980's. The spread between total funding and the fixed costs of the program (administration and debt

<sup>8</sup> Total project funding equals total revenues less debt service and administrative costs.

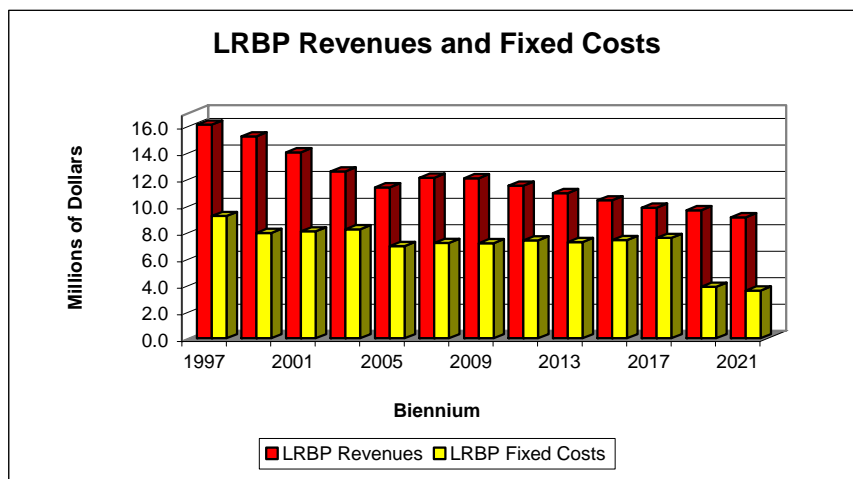
service) continues to diminish, leaving fewer dollars available for funding projects. Currently, the level of funding is not sufficient to maintain the recommended level of major maintenance on state buildings, causing growth in the backlog of deferred maintenance.

## FIXED COSTS

Fixed costs of the LRBP consist of program administration and debt service. As observed in the chart to the right, fixed costs have actually decreased over the last decade. This is the result of reissuing bonds to obtain a lower rate of interest.

The LRBP coal supported debt service obligation has decreased from a level of \$6 million per biennium in 1996 to approximately \$4.5 million in the 2007 biennium. Administrative costs over the period have grown at a rate of 4.7 percent annually.

In the chart to the right, the difference between the two sets of bars represents the funding that remains for major maintenance projects in the LRBP. In the 1997 and 1999 biennia, fixed costs usurped approximately 55 percent of total revenues, leaving just under \$7 million for projects. By the 2017 biennium, estimates show that 76 percent of revenues will be expended on LRBP fixed costs, leaving only \$2.3 million for major maintenance projects. When the coal severance tax debt service is paid in the 2019 biennium, the funds remaining for the LRBP will increase to nearly \$5.5 million.



\*Revenues in the 2007 biennium do not include the one-time general fund transfer of \$30.1 million.

## PROJECT FUNDING

Diminishing revenues have dramatically reduced the funding available for major maintenance. The current funding methodology provided only \$4.5 million for projects in the 2007 biennium. The recommended rate of funding is \$23 million. Consequently, the state funds building maintenance at only 20 percent of the recommended level. Furthermore, to abide by the recommendation on a continuing basis, funding would need to grow by 3.2 percent annually. Instead, the funding is expected to diminish by 60 percent over the next decade.

As observed in the revenues and fixed costs chart in the previous section, there will always be some funds available for maintenance projects in the LRBP cash program. However, by 2017, when the current funding methodology will produce only a projected \$2.3 million, funding will not be adequate for required projects such as roof replacements, hazard materials mitigation, and life safety projects<sup>9</sup>. Average spending for these projects over the past decade was \$2.5 million, and that figure is projected to grow to \$2.9 million by the 2017 biennium.

<sup>9</sup> Projects that are required to meet the specifications dictated in codes and the Americans with Disabilities Act.

## **CONCLUSION**

The LRBP cash program is seriously under-funded, as recognized by the 2005 Legislature. Consequently, the 2005 Long-Range Planning Subcommittee recommended and the Legislature approved an appropriation of \$8,000 to conduct a study and make recommendations to provide adequate funding for the LRBP cash program. Current funding provides only 20 percent of the recommended funding for major building maintenance. While the deferred maintenance backlog will be reduced somewhat during the 2007 biennium, the backlog will continue to grow. Revenues will continue to decline in the upcoming years, causing greater stress on the program and further expanding the backlog.

To fully fund the LRBP cash program and eliminate the deferred maintenance backlog, substantial changes in program funding will be necessary. To fund cash program maintenance at recommended levels, initial estimates show that \$23 million will be needed each biennium. That amount will need to expand with inflation and additions to the state inventory of buildings, estimated at near 3.2 percent annually. Additional funding may be needed to eliminate the current backlog of deferred maintenance, currently estimated at \$142 million. If full funding for the ongoing costs is acquired, the deferred maintenance backlog would grow only with inflation, and the backlog would not increase as substantially as shown in this analysis. Potentially, full program funding could be sufficient to ease or eliminate the backlog. Future analysis will be aimed at answering this question.

Backlogged deferred maintenance is a significant problem and can have severe consequences for the state, as seen in the case of the Montana State University (MSU), Gaines Hall project. Since the original construction in 1957, there was little adaptive renovation to provide modern teaching and research accommodations at the facility. Code upgrades and life safety projects were continuously pushed into the deferred maintenance backlog. The heating, ventilation, and air conditioning (HVAC) and secondary electrical systems no longer adequately met the needs of the building. These projects were also placed on the deferred maintenance lists. The Gaines Hall project did receive some renovation funding in the 2007 biennium, but not before conditions grew so grave that MSU faced suit by a former student claiming injury related to the inadequate ventilation. The 2005 Legislature appropriated \$3.5 million in bonded funds for a portion of the required renovations. If the cash program were adequately funded, much of the planned renovation at Gaines might have been commenced earlier when the costs would have been less and before the facility reached such a severe status. Money might have been saved both in terms of project costs and as a result of reduced state litigation.

## **COMMITTEE PARTICIPATION**

This report provided a preliminary assessment of the inadequate funding of the LRBP cash program and resulting deferred maintenance backlog. LFD staff will work with A&E staff to complete an in-depth study and make recommendations to the LFC. Staff plans to provide a report and recommendations/options to the LFC at the June 2006 meeting of the LFC. The following options are offered for the LFC participation in the study.

1. Convene a subcommittee to study funding methodologies for the LRBP cash program and make recommendations to the Finance Committee.
2. Work in full committee to develop new funding methodologies for the LRBP cash program and present recommendation to the 2007 Legislature.